HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. ■ Ranking Democratic Member

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May 9, 2002

Significant Downward Revisions of the 10-Year Surplus Won't Surprise Democrats

"There is not more than enough room for the President's tax relief plan. There is vastly more than enough room... Being, as I think a banker would look at it, over-reserved against the unknown, we have fully enough money left to give a refund to the American taxpayer... The budget is built on very conservative and cautious assumptions... The revenue relative to GDP numbers are extremely cautious."

Mitchell Daniels, Director of the Office of Management and Budget
White House Bulletin, February 28, 2001

"Fiscal responsibility used to be about as common in this town as Halley's comet, but we put the tax-and-spend century behind us. We are here today to replace it with a century of surplus."

House Majority Leader Richard Armey
Congressional Record, H1270, February 28, 2001

Dear Democratic Colleague,

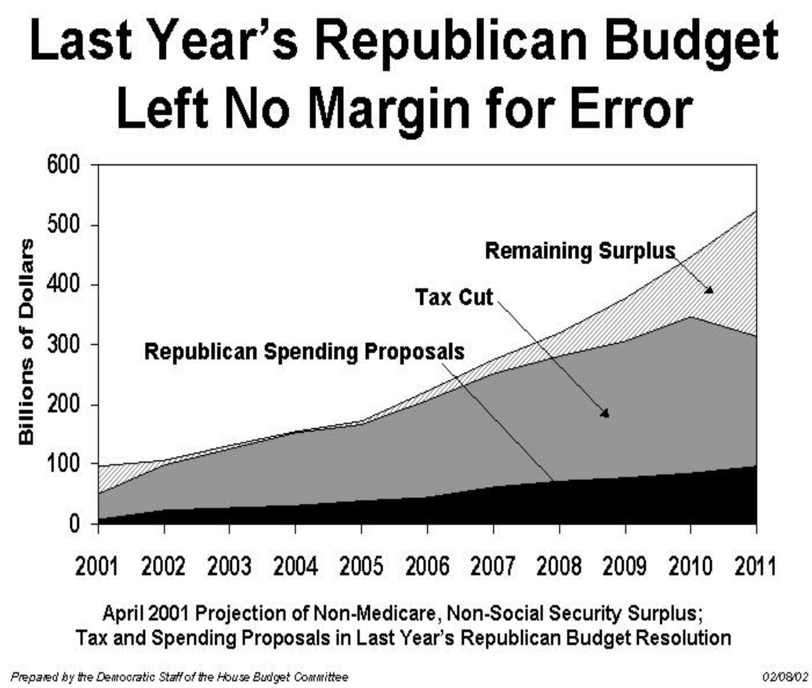
Recent news reports indicate that receipts are coming into the Treasury this year much weaker than expected, and the Treasury Secretary has again asked for an urgent increase in the statutory debt ceiling to avoid a government default. It may be still too soon to conclude, as some have, that the deficit this year will be four times as large as predicted just a few months ago. However, the fact that we are so uncertain about the deficit ***right now*** should inspire at least a measure of humility about the reliability of projections ten years hence. Indeed, there are good reasons to wonder whether OMB's and CBO's projections of the ***long-term*** surplus are still too rosy and will be revised down as well.

Democrats' Warned Against Leaving No Room for Error

Republicans complained that they were taken by surprise when the Congressional Budget Office (CBO) reported in January that $4.0 trillion had disappeared of what had been a $5.6 trillion surplus for 2002 through 2011. They maintain that the $4.0 trillion collapse resulted from unexpected events — namely, the economic slowdown and spending related to the September 11 attacks.

However, both OMB's and CBO's figures clearly show that last year's tax cut was the single largest factor in the deterioration. According to OMB, it accounted for 43 percent of the slump in the surplus, while other legislation accounted for 17 percent and economic factors and technical changes accounted for 40 percent. Democrats, at least, were not surprised that the ten-year tax cut, plus its resulting impact on interest payments on the public debt, had a large impact on the ten-year surplus.

Nor were Democrats surprised by the fact that the combination of economic and technical factors turned against us so quickly. We had cautioned that this danger was the most important argument against the Republican budget that committed trillions of dollars for years to come and left no room for error. We warned that centering the budget on a Republican tax cut that consumed essentially all of the surplus outside of Social Security and Medicare was a risky gamble.



Democrats Warned That Past Upward Revisions Might Now Reverse

Democrats also noted that there was good reason to fear that future revisions might be downward, reversing the string of consecutive upward revisions in the late 1990s.

> "CBO says that its current budget projections may be subject to even greater error than in the past...[saying] 'The longer-term outlook is also unusually hard to discern at present.'...CBO calculates that there is about a one in five chance that the budget outside of Social Security and Medicare will be in deficit after 2003."

Budget Talking Points
House Budget Committee Democrats, February 12, 2001

> "CBO's recent budget re-estimates have shown a similar variation — which means that large re-estimates, perhaps in the opposite directions are possible....Over the past year alone, CBO has increased its surplus projection by $2.5 trillion. Over the past three years, CBO has increased its surplus projection by almost $5 trillion....Similar re-estimates could occur again, going in either direction."

Long-Term Budget Estimates Are Unreliable
House Budget Committee Democrats, May 24, 2001

Recent History of Budget Revisions

Impact on Ten-Year Surplus, Billions of Dollars, CBO

Change From:	Period:	Economic Factors	Technical Factors	**ECON/TECH TOTAL**	Legislation: Revenues	Legislation: Outlays	**LEGIS. TOTAL**
Jan 97 to Sep 97	1998 - 2007	1071	419	**1490**	-242	837	**595**
Sep 97 to Jan 98	1998 - 2007	119	322	**441**	1	1	**2**
Jan 98 to Aug 98	1999 - 2008	214	692	**906**	2	-22	**-20**
Aug 98 to Jan 99	1999 - 2008	348	448	**796**	-2	-49	**-51**
Jan 99 to July 99	2000 - 2009	261	106	**367**	0	-36	**-36**
July 99 to Jan 00	2000 - 2009	640	366	**1006**	-18	-109	**-127**
Jan 00 to July 00	2001 - 2010	832	644	**1476**	-6	-61	**-67**
July 00 to Jan 01	2001 - 2010	980	59	**1039**	-37	-561	**-598**
Jan 01 to Aug 01	2002 - 2011	-283	-158	**-441**	-1186	-585	**-1771**
Aug 01 to Jan 02	2002 - 2011	-645	-501	**-1146**	-19	-630	**-649**

Democrats Warned Against Betting the Budget on the Stock Market

In fact, Democrats correctly pointed out what is now the greatest downside risk to the budget — CBO's very high assumptions about the amount of revenue forthcoming from every dollar of GDP. The ratio of revenue per dollar of GDP is quite sensitive to movements in income related to stock market performance — like capital gains, stock options, executive compensation, and bonuses — because most of this income is not included in GDP. As the stock market soared in recent years, the ratio of revenue to GDP rose to record highs, but it may now retreat given the market's decline.

> "One of the reasons for the growing budget surpluses over the past few years has been higher capital gains tax revenue as a result of the booming stock market....Mark Zandi, Chief Economist at Economy.com, explains, 'We've had years of stock-juiced surpluses at all levels of government. But a flat equity market will quickly weigh on government's good fiscal fortunes.'"

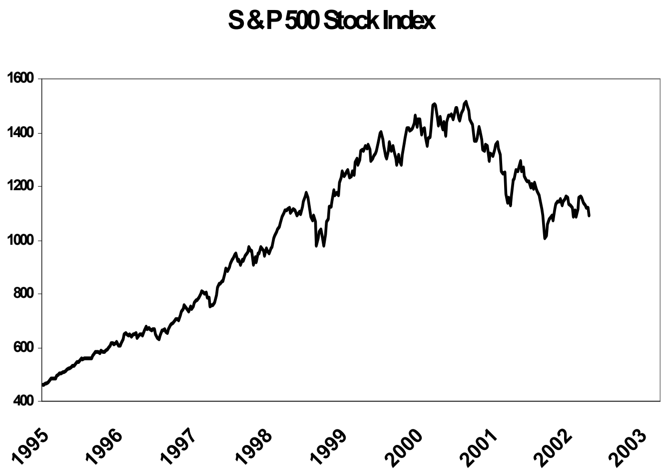
Ten-Year Budget Surplus Estimates Are Unreliable
House Budget Committee Democrats, March 12, 2001

> "There are good reasons to expect that revisions of the surplus in coming months will be negative....[T]he amount of revenue generated by every dollar of GDP is likely to decline sharply in the short run and may not recover much in the long run. The ratio of revenues to GDP had risen to record levels, and until recently both OMB and CBO had assumed that it would retreat only modestly. However, with weaker growth of income tied to the stock market — like capital gains, stock options, executive compensation, and bonuses — the revenue from such sources may well reverse its earlier disproportionate growth. Even small changes in the ratio of revenues to GDP can have major impacts on the budget."

Republican Stimulus Proposals Make a Bad Situation Worse
House Budget Committee Democrats, December 13, 2001

Thus, Democrats already were arguing a year ago that the unusual run-up during the late 1990s of tax receipts per dollar of GDP could easily reverse, given the market decline unfolding at that time. Now, the sharply lower level of receipts in April 2002 appears to confirm this prediction. The largest component of the recent revenue shortfall is taxes on non-withheld income, where one would expect severe stock-market effects.

Except for a sharp dip right after the September 11 attacks, the S&P 500 stock index has been hovering for about a year just over 1,000. The market may well continue to hold at this level, not seen since 1998 and almost 30 percent below its peak 16 months ago. In this event, receipts ***next*** April may also be weak as unlucky investors continue to take capital losses, let stock options lapse, or fail to garner bonuses.



Even if the S&P 500 Index rose steadily to 1,300 by the end of the year, its average for this year would still be a bit below last year's. That would suggest that the depressed income from capital gains, stock options, bonuses, executive salaries, and the like might still hold down revenues in 2003, contributing to a continuing deficit, even if the stock market starts to rise again.

Democrats Are Now Warning About Sustained Downward Revisions of the Ten-Year Outlook

Several analysts are predicting weaker profits growth for the next few years, which would tend to keep stock prices low. Certainly, few people expect the economy to replicate the extraordinary 4.0 percent economic growth averaged over the second half of the 1990s, and this alone could mean more sluggish profits. This could mean that incomes related to stock market performance — and the revenues related to them — might remain depressed for some time, leading to a sustained decline from recent peaks of the amount of revenue per dollar of GDP.

Even tiny changes in the ratio of revenues to GDP, if sustained, can have significant impacts on the budget deficit. For instance, if this ratio is held just 0.1 percentage point lower than currently assumed, the ten year surplus is reduced by about $150 billion. If the ratio of revenue to GDP were to drop sharply now and take several years to recover to the levels assumed by OMB and CBO, it could easily knock more than $500 billion off the ten-year surplus. If the ratio dropped and stayed well below the levels that forecasters assume, the effect might be $1 trillion or more.

Changes of as much as a percentage point in the ratio of revenues to GDP are well within the range of historical experience. CBO has derived probability bounds for its forecasts based on its past forecast errors. Using these probability calculations, the bipartisan, bicameral Budget Committee Members who convened immediately after the September 11 attacks concluded that there was a 50 percent chance that the ten-year surplus might be at least $2.3 trillion higher or lower than projected at that time. While substantial upward revisions of the projected surplus may still be possible, counting on them at this point is like betting the budget on the stock market.

The substantial uncertainties surrounding ten-year budget forecasts reinforce Democrats' arguments. Congress should exercise caution with regard to long-term commitments of budget resources that may never materialize. After all, if budget forecasts turn out to have been too pessimistic, the Congress can always vote for additional tax relief in subsequent years. However, if instead the budget forecasts turn out to have been too optimistic — as is the case now — it is difficult to repair the damage of earlier imprudence.

> "I hope that these blue-sky projections that total some $5.6 trillion in surpluses over the next ten years will materialize. It will be a great bounty for all of us. But if they do not and if we pass this [budget] resolution, we can find ourselves right back in the red again in the blink of an economist's eye."

Representative John M. Spratt
Ranking Democrat, House Budget Committee
Congressional Record, March 28, 2001

> "The headline estimates of GDP growth and unemployment suggest that the recession was much milder than CBO had anticipated. However, taxable income seems to have taken a much more significant hit than the GDP figures suggest. And CBO received confirmation last week that the Bureau of Economic Analysis (BEA) significantly overestimated wage and salary income in 2001."

CBO Director Dan Crippen
Testimony before the House Budget Committee, May 2, 2002

Sincerely,

John M. Spratt, Jr.
Ranking Member